Kentucky League of Cities
RESEARCH BRIEF

Hybrid Approaches to Public Pension Plans

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Over half of Kentucky cities currently participate in the County Employees Retirement System (CERS), which represents around 95 percent of all cities that offer employee retirement benefits. CERS is a defined benefit pension that provides retirement benefits based on a calculation combining years of service, average final compensation and a benefit factor. A number of counties, school districts, special districts and other governmental entities participate in CERS, which is administered by the Kentucky Retirement Systems (KRS).

Defined contribution plans are retirement accounts in which an employee, and often an employer, contributes a set amount or percentage of pay. The contributions are invested on the employee's behalf, and the benefits upon retirement are based on the contributions and their investment gain, or loss, over time. Some examples of defined contribution include the 401(k) and 457(b) accounts, which are referred to by their reference in the Internal Revenue Code.

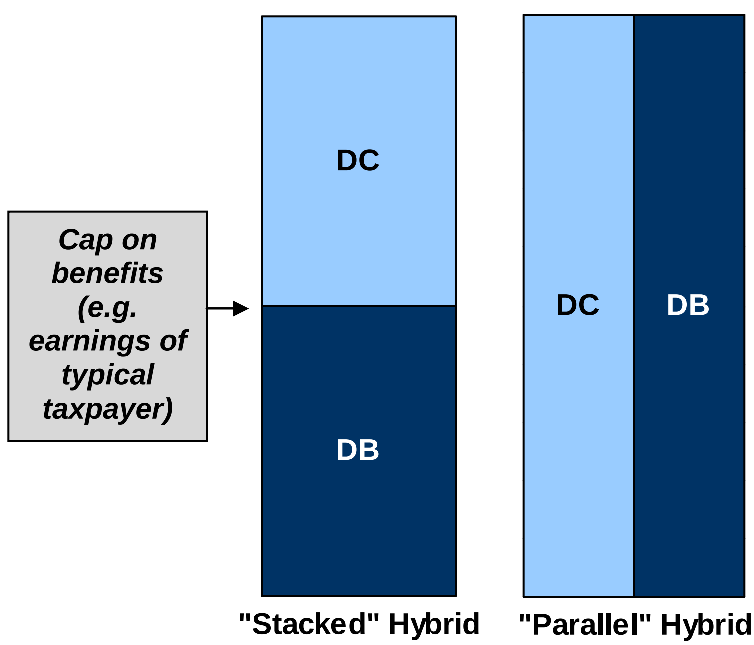
Defined benefit plans have been around for many years. While the private sector more recently has moved almost exclusively to defined contribution plans, defined benefit plans are still predominant in the public sector. Although several legislatures have attempted to move from defined benefit to defined contribution plans, many have also evaluated hybrid pension plans. Hybrid plans combine aspects of both the defined benefit and the defined contribution accounts.

Types of Hybrid Pension Plans

Most hybrid approaches to retirement systems are typically known as "parallel" hybrids. These hybrid plans have both a defined benefit (pension payments) and a defined contribution (personal investment account). They run side-by-side, meaning an employee, no matter his or her pay, has both defined benefit (DB) and defined contribution (DC) accounts (see chart).

Another type of hybrid approach is what's known as a "stacked" hybrid. Much like the parallel hybrid, these plans have both a defined benefit and a defined contribution. However, instead of running side-by-side, the defined contribution (DC) is stacked on top of the defined benefit (DB). The defined benefit is capped at some figure, such as a level no greater than or equal to the earnings of a typical taxpayer. Any earnings by the active employee above that level go toward their defined contribution account (see chart).

Stacked vs. Parallel Hybrid Plans



A parallel hybrid provides greater portability and more earnings potential, particularly for high-income pension participants. But, parallel hybrids still have a high risk to taxpayers, a high risk to retirees and less security for lower income workers.

A stacked hybrid provides the full protection of a defined benefit plan to workers with low to modest earnings. These public employees would be the most vulnerable if required to contribute solely or in part to a defined contribution account. If given the option, they likely would not participate, leaving them with little to no retirement security. If they are mandated to contribute, they likely wouldn't earn enough through their investments to safely retire.

A stacked hybrid also ensures that taxpayers do not fund significantly above average retirement benefits. More highly paid public employees in the retirement system would have the defined benefit plan as their base pension. In addition, they would have a defined contribution [such as a 401(k) or 457(b) account] to help replace their earnings above the typical taxpayer. This system ensures no "golden parachutes" for very highly paid public employees.

Calculating Hybrid Plans

The defined benefit provided by the County Employees Retirement System (CERS) is currently calculated based on the following formula:

Annual pension benefit	=	Years of service	x	Benefit factor	x	Final compensation

A parallel hybrid plan would change this formula very minimally, focusing solely on the benefit factor used. The benefit factor used depends on start date in the system, whether service is hazardous or non-hazardous, and how much service credit an employee has. Under a parallel hybrid, the benefit factor would be reduced, usually by one-half. So, if the normal benefit factor would be 2.0 percent, then the parallel hybrid benefit factor might be reduced to 1.0 percent. Typically the employee contribution is also cut in half for this portion of the benefit.

In a stacked hybrid plan, the formula would be used to solve for the "final compensation" variable, since the annual pension benefit would be capped. Employees would only pay the defined benefit contribution up to the maximum salary amount that would produce no more than the annual pension benefit cap. Any earnings above that cap would be subject to the defined contribution only.

The defined contribution portions would function very similarly in the two types of hybrid plans. The employees, and possibly employers, would contribute a percentage of their salaries to the defined contribution account, which would be portable if they switched to a job outside of the public system. In the parallel hybrid, employees would pay into the accounts regardless of their pay. In the stacked hybrid, employees would only pay into the accounts once their salaries went above the maximum salary amount for the defined benefit portion.

Impact on the Average Employee

A parallel hybrid plan would be significantly different for the average employee. Instead of receiving a defined benefit calculated on 100 percent of their earnings, employees in this plan

Parallel Hybrids:

- **Provide long-term growth in personal investment accounts.**
- **Are more portable if switching from the public to private sector.**
- **Do not provide much security for low-income employees.**
- **Do not significantly reduce taxpayer risk.**

Stacked Hybrids:

- **Provide a base pension for all workers.**
- **Prevent "golden parachutes" for public employees.**
- **Do not shift as much money into personal investment accounts.**
- **Do not provide as much long-term growth in personal investments.**

would only receive half of their defined benefit portion. However, they would have access to a defined contribution account that has a significant amount of contributions and gain or loss over time.

A stacked hybrid plan would change very little for most employees in CERS. Over half of the non-hazardous duty employees currently in CERS are employed by local boards of education. CERS covers the classified employees in schools, or the non-teaching personnel. These include office assistants, cafeteria workers, bus drivers, etc., many of which are not year-round, full-time equivalent jobs. These typically bring down the average salary in CERS ($26,694 in FY 2011). So, most of these employees would see no change from switching to this plan. Higher paid employees of cities, counties, special districts, quasi-governmental agencies and others would exceed the defined benefit cap, therefore likely reducing the pension payment they would receive compared to the current CERS structure.

Hazardous duty employees are more likely to be affected by a stacked hybrid system since they are all full-time equivalent employees with comparatively higher salaries. For instance, in FY 2011, the average salary for a hazardous duty employee in CERS was $49,640. The average final compensation for initial retires was $58,814 that fiscal year. Both of these averages are more than the likely defined benefit cap. So, upon retirement, their final compensation would be limited due to the cap, which would reduce the annual pension payment the employees would receive. Of course, these affected employees would have the defined contribution account to complement the defined benefit plan.

Impact on the Retirement System

Both hybrid plans would impact the Kentucky Retirement Systems due to the changes in plan administration. Adding personal investment accounts would make it more difficult to administer, although the Kentucky Public Employees' Deferred Compensation Authority may be able to manage the defined contribution accounts more efficiently.

CERS is largely funded through a "pay as you go" system in which active employees and employers largely fund the benefits paid to retired participants. Therefore, any switch to a hybrid retirement plan must also consider the short-term funding impact on the actuarial liability of the system.

Questions? Contact the KLC research team at 1-800-876-4552.